

testimony



STATEMENT OF
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DEPARTMENT OF DEFENSE
BEFORE THE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT
INFORMATION AND TECHNOLOGY
HOUSE GOVERNMENT REFORM COMMITTEE,
UNITED STATES HOUSE OF REPRESENTATIVES
ON
DEFENSE FINANCIAL MANAGEMENT

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Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity today to provide the views of the Office of the Inspector General on the challenges faced by the Department of Defense in efforts to account for its funds and physical assets, provide useful financial information to decision makers, and operate its huge payroll and contractor payment operations efficiently.

Major DoD Financial Management Issues.

In testimony before this subcommittee almost exactly one year ago, the Deputy Inspector General described the huge scope and unparalleled complexity of DoD finance and accounting operations, as well as the Department's realization during the 1990's that virtually all of its administrative processes were outmoded and unaffordable in their current forms. Likewise, new statutory requirements for audited annual financial statements caught the Department unprepared and without the automated systems needed to compile commercial type accounting data. Along with all other DoD management sectors, the financial management community embarked on a long-term reform effort with particular emphasis on developing a new generation of modern, more standardized and networked systems. Last year we provided

our assessment that neither the full integration of DoD support operations, including financial management, nor the achievement of clean audit opinions on the consolidated DoD financial statements were feasible short term goals. We continue to believe, as stated in last year's testimony, that the Department remains a few years away from being able to achieve favorable audit opinions on most major financial statements. The testimony last May covered a number of specific concerns, including:

- The longstanding difficulty in measuring the progress made to improve financial reporting and the danger of focusing on audit opinions on financial statements as the only metric;
- The paramount importance of developing properly integrated, reliable financial information systems;
- Overly complex contracts and accounting requirements.

Today I would like to offer our observations on where each of those matters stands, as the DoD enters its second decade of post-Cold War management reform and restructuring.

Financial Reporting. The DoD efforts to compile and audit the FY 1999 financial statements, for the Department as a whole and for the 10 subsidiary reporting entities like the Army, Navy and Air Force Working Capital Funds, were massive. Nevertheless they could not overcome the impediments caused by poor systems and inadequate documentation of transactions and assets. In terms of opinions, the audit results differed little from the previous year. A clean opinion was again issued for the Military Retirement Fund, but disclaimers were necessary for all other funds, including the DoD-wide consolidated statements.

The General Accounting Office (GAO) written testimony elaborates on the results of our audits in considerable detail, so I will not repeat the rather lengthy list of deficiencies that precluded favorable audit opinions. We agree with GAO's summary of those problems, as well as the overall assessments by both the GAO and the DoD that the Department is making progress toward compliance with the new Federal Accounting Standards.

Audit opinions on the DoD-wide and major fund financial statements still are the sole widely used metric for quantifying progress. Unfortunately, this means that considerable improvement can be made in each of the huge DoD reporting entities without any effect on the overall audit opinions.

For example, the Air Force made a concerted effort to correct records and compile support for transactions so that a favorable audit opinion could be achieved on its Statement of Budgetary Resources (SBR). Notwithstanding these numerous improvements and corrections, the effort could not overcome the problem of an unreliable opening balance. Work continues on the ending balance for FY 1999. Despite a relatively near miss, the Air Force SBR audit result is scored as another failure, a disclaimed audit opinion, but this is only part of the story.

Although the DoD has put considerable effort into improving its financial reporting, it seems that everyone involved--the Congress, the Office of Management and Budget (OMB), the audit community and DoD managers--have been unable to find out or clearly articulate exactly how much progress has been made, what is the planned pace of further action, how much remains to be done and how much risk exists in terms of meeting goals and schedules. Nor has it ever been clear how much the various aspects of this effort have cost to date, how much more will be needed and whether the effort is sufficiently resourced.

Ironically, although the Department annually compiles voluminous documents in response to statutory requirements for multi-year financial management improvement plans and other data, very

little of that information is consistently updated, analyzed and used for day to day program management or frequent senior management oversight. Much of it has to be collected in annual data calls to the DoD component organizations. The various reports to OMB and Congress, the annual financial statement audits, and even supplementary audits cannot substitute for structured, readily accessible, meaningful and frequent internal management reporting. Current data on project performance, cost and schedule status should be routinely provided up a clearly defined program management chain and shared with external reviewers.

Currently, a lot of crucial management information exists, but it is dispersed in various organizations and databases. A few years ago, in response to advice from the IG, DoD, the Defense Finance and Accounting Service centralized its management of system acquisition projects into a single program office, which was a significant improvement. That office endeavors to track and coordinate systems development and modification efforts for a couple of hundred systems, most of which it does not own or control. Various other DoD components have organized teams and established internal reporting requirements to track their Chief Financial Officer (CFO) Act compliance progress. The Under Secretary of Defense (Comptroller) has agreed to track the

status of various actions that his office, OMB, GAO, and the IG, DoD, have jointly developed and agreed to as part of the effort to address impediments to acceptable financial statements. Also, the IG, DoD, and the Military Departments track the status of management action on all audit recommendations.

In our view, the Department needs to determine how best to collate and share available information, establish any additional metrics needed and require sufficient internal reporting to enable the CFO Act compliance effort to be managed, monitored and controlled as a well integrated program.

In our November 1999 report, "Deficiencies in FY 1998 DoD Financial Statements and Progress Toward Improved Financial Reporting," we recommended that DoD emulate its highly successful "Y2K" management approach to address the challenge of attaining CFO Act compliance. As was the case with the Y2K conversion, the CFO Act challenge has been designated by the Secretary of Defense as a high priority. Similarly, achieving CFO compliance is fundamentally a systems problem, could have goals, criteria and milestones set forth in a clear management plan, involves all DoD organizations and functional communities, and cannot be overcome by the primary functional proponent without the active assistance of the rest of the Department.

Likewise, both efforts have entailed extensive audit verification and testing, and the Congress, OMB and GAO are all strongly interested in measuring progress toward the goal. There would be several advantages to this approach. The Department knows it works, managers are familiar with terminology related to defined phases and system status, and it entails fairly simple and verifiable metrics to show progress and highlight risk areas.

Although the Department reports in its current Financial Management Improvement Plan that the Y2K concept has been adopted, implementation has been disappointingly slow.

The Plan of September 1999 established March 31, 2000, as the milestone for completing the Assessment Phase for CFO Act compliance of 168 critical systems. Despite the Y2K program experience that initial system assessments and status reports often were overly optimistic, incomplete or inconsistent, audit community involvement in validating milestone status has been limited. There has been no feedback on whether this key March 31 milestone was met and what the reported results were.

We plan to work even more closely with the Department over the next several months to apply lessons learned from the Y2K

experience to various other DoD-wide information system challenges. In addition to CFO Act compliance, information assurance and oversight of system development projects are areas where we recommend Y2K-like management approaches.

Systems Problems

Over the past year, two issues have underscored the severity of the problems faced by DoD because of inadequate financial systems and the challenges involved in new systems development.

The first issue relates to how DoD financial statements are compiled. When the financial reporting system of a public or private sector organization cannot generate fully reliable financial statements, accountants sometimes make accounting entries, often as recommended by auditors, to complete or correct the statements. Making major entries or adjustments is not the preferred way of doing business and there is considerable attention paid to any significant change made to official accounting records. The notion of accounting entries being made on a mass scale is completely foreign to Corporate America, as is the prospect of such adjustments being unsupported by clear audit trails.

The audits of the 1999 DoD financial statements indicated that \$7.6 trillion of accounting entries were made to compile them. This startling number is perhaps the most graphic available indicator of just how poor the existing systems are. The magnitude of the problem is further demonstrated by the fact that, of \$5.8 trillion of those adjustments that we audited this year, \$2.3 trillion were unsupported by reliable explanatory information and audit trails.

The second issue concerns the management of information system development projects. The Department has been working throughout the 1990's to reduce the number of separate systems and to develop replacements for inadequate legacy systems. Unfortunately, information systems development in the Federal Government is a lengthy proposition. The DoD efforts to develop the next generation of financial systems have had to contend with slowly evolving, but very significant, changes in Federal accounting standards. Also, most DoD modernization and investment programs have faced severe competition for resources. Finally, the Y2K problem may have distracted managers and exacerbated existing resource problems to some extent. Currently, the DoD plans to field all of the systems needed to achieve CFO Act compliance by FY 2003. We regard that as an overly optimistic forecast. Meeting information technology

system development schedules is frequently a problem in both the public and private sectors; the DoD is no exception.

The Department's application of Clinger/Cohen Act principles to development of the Defense Joint Accounting System (DJAS) was severely criticized in the House Appropriations Committee Report on the National Defense Appropriations Act for FY 2000. DJAS is one of the four systems chosen to be the next generation of accounting systems replacing numerous legacy systems used by the Army and most Defense agencies. The Committee wrote:

"Despite the importance of developing joint systems, the Department has allowed the Air Force and the Navy to opt out of this program and to develop and modernize their own distinct systems. Thus, this "joint" system will be fielded only to the Army and a few defense-wide activities. After its initial Milestone 0 approval, the timeline for completing the DJAS software development effort expanded from 16 months to six or more years, the benefits declined from \$322,000,000 to \$204,000,000 and are now characterized as 'productivity savings', whereas before they were real cost savings. In November,

the DoD IG issued a draft report warning that DJAS had not completed the steps required under the program management process to be prepared for a Milestone I review. In March, the Office of Program Analysis and Evaluation issued similar warnings about the dramatic change in the programs scope, cost, and duration. Despite these serious concerns, the Department not only issued Milestone I approval, but also Milestone II approval at the same time, all without having a meeting of the IT OIPT to review the system. The Committee rejects this approval as inconsistent with the intent of the Information Technology oversight process and the Clinger-Cohen Act."

We are currently auditing the status of the DJAS project, as requested by the House Appropriations Committee. We have not yet officially reported on the matter, but initial results indicate continued problems complying with Clinger/Cohen Act requirements for careful management oversight when making investment decisions. DJAS life cycle cost would be about \$.7 billion. I point to this issue principally to emphasize that more review of the dozens of other systems projects related to

CFO Act compliance is likely to indicate other risks and issues. Implementing the Clinger/Cohen Act is still ongoing in DoD. We are putting high priority, to the extent our constrained audit staffing and budget levels permit, on supporting the Chief Information Officer in his oversight role regarding all information technology projects, including those for financial systems.

Useful Financial Data

In adopting the private sector practice of audited annual financial statements, the Congress clearly expected improved financial management.

The lack of performance metrics and cost data that I previously discussed handicap an assessment of whether the effort to attain auditable financial statements has been worthwhile. The key question to be asked, however, is whether data produced in compliance with Federal Accounting Standards and audited in financial statement audits is useful to users--managers and the Congress. Because much of the data rolled up into annual financial statements is also provided to users in various reports and budget exhibits, often periodically during the year,

the focus should be across the spectrum of financial information reported within and by the Department, in whatever form.

Questions on the usefulness of various financial reports can best be answered by the users, not auditors. Unfortunately, we are unaware of much feedback to the DoD CFO community along those lines from other managers or Congress. Hopefully this dialogue will expand in the future, so that the accounting community has the best possible idea of what managers and the Congress actually need, when and in what form.

Financial statement audit results can be very arcane. In my view, some of the asset valuation issues will never have any impact on DoD decision making. However, other management information deficiencies identified during these audits have very practical implications. At last year's hearing, the inaccuracy of DoD inventory data was discussed at length. As noted in our audit reports and the GAO testimony today, inventory accuracy remains a problem. Likewise, the inability to determine actual patient workload and costs in the DoD health care program is still a concern. Today I would like to discuss two other types of data, environmental liabilities and fund status information. In both cases, the data can be used for multiple purposes and the controls over accuracy are important.

Environmental Liabilities

We were unable to verify the \$79.7 billion reported for environmental liabilities on the FY 1999 DoD Agency-wide Balance Sheet. The reported amount, as large as it may seem, was clearly understated.

The magnitude of DoD environmental cleanup requirements has been a matter of intense DoD and Congressional interest for many years, but information on costs is fragmented and often unreliable. It would seem logical that costs identified in budget exhibits, other DoD environmental program reports, Selected Acquisition Reports and financial statements should be as consistent as possible, reconcilable and supported. More work is needed to move toward that goal. Specifically, there are unresolved policy issues regarding when to recognize environmental disposal costs for other than nuclear powered weapon systems on financial statements. Also, the support for many of the cost estimates that were included was inadequate.

For example, the \$20.7 billion equipment disposal portion of the \$79.7 billion overall environmental liability estimate was clearly incomplete, although improved over previous years. The

Air Force reported nothing. The Navy, in contrast, estimated \$11.5 billion for nuclear-powered submarine and ship disposal. This was the first time that those amounts were included in the financial statements. An open issue remains on when to recognize disposal costs for most DoD weapon systems on the financial statements--as soon as estimates are made as part of initial weapon system life cycle costing or much later when disposal decisions are made. We are working with the Department and GAO to resolve the question. Regardless of the decision, we have recommended more aggressive action by the Military Departments to ensure that acquisition program managers include hazardous waste handling and disposal costs in the total estimated ownership costs of their systems. Last week we published a report, "Hazardous Material Management for Major Defense Systems," which recaps the results of audits of nine weapon system programs. Those audits indicated commendable emphasis by program managers on reducing the amount of environmentally hazardous material that will require costly disposal, but virtually no emphasis on including disposal costs in life cycle cost estimates.

The DoD reported \$34 billion as the liability for environmental cleanup of unexploded ordnance at training ranges. Reporting this amount represents a significant improvement over FY 1998,

when cleanup liabilities for training ranges were not recognized or reported at all. However, reporting was incomplete. Although final DoD guidance for reporting liabilities for cleanup of training ranges has not yet been published, it is expected in FY 2000.

The Army, as DoD's Executive Agent managing the Chemical Demilitarization Program, reported about \$8.9 billion in environmental liabilities for FY 1999. Further work is needed to validate the support for those estimates, which are particularly important because of the ongoing effort to dispose of the chemical weapons stockpile.

Fund Status Data

The most fundamental budget execution and fund status data maintained by DoD, and relied on by managers at all levels, relates to amounts of authorized funding, obligations, unobligated balances, outlays and unpaid (unliquidated) obligations. Because of the Antideficiency Act, which prescribes criminal penalties for obligations or expenditures in excess of appropriated amounts, and the desire to use all funds efficiently, the primary purpose of DoD financial management information systems over the years has been funds control.

Based on results of audits of obligations and unpaid obligations shown on the Statements of Budgetary Resources in the annual financial statements, we continue to consider funds control a concern. The data for the SBR is drawn from the same sources as data for the monthly SF133 Report on Budget Execution and for the prior year actual column of individual appropriation program and financing schedules, a fundamental budget exhibit.

Audits of FY 1999 financial statements indicated problems with the accuracy and support for reported fund status data.

For example, Air Force auditors projected that \$1.3 billion of \$36 billion of unpaid obligation balances were invalid.

Although this is not a large percentage, and may be adjusted downward as review continues, the Air Force has numerous unfunded requirements and it is cause for concern when over a billion dollars is unavailable for use because of inattention or administrative error. Likewise, in audits of two Defense agencies, we found 70 percent of obligations in one sample and 48 percent in the other to be invalid.

To ensure accurate fund status reporting, DoD must continue efforts to eliminate unmatched disbursements, reemphasize the

need for supporting documentation, implement better integrated systems and motivate managers to comply more diligently with DoD policy for periodic review of unpaid obligations. The DoD has reported steady progress in decreasing the level of problem disbursements from \$17.3 billion in September 1998 to \$10.5 billion in September 1999. These reports are encouraging, but this problem needs to be kept at the forefront of management's attention.

Simplifying Requirements

In the mid-1990's, we recommended that DoD and the Congress consider ways to reduce the burden on DoD accounting offices and the risk of errors by simplifying requirements. The Under Secretaries of Defense (Comptroller) and (Acquisition, Technology and Logistics) have pressed the DoD components to adopt measures to avoid the unnecessary use of multiple accounts on contracts and commingling of funds from different accounts on the same contract line item. Likewise, our office has periodically commented on the incredible complexity of the DoD chart of accounts, which is probably unique in the world because of its hundreds of thousands of accounting entities, and the absurdly long accounting codes that result. Those codes must be applied to many million transactions a year.

Unfortunately, the budget and appropriation structures are difficult to change. The DoD must administer at least 1,200 open appropriation accounts at any given time. The main driver of complexity, however, is the business practice of the individual DoD component. The Army, for example, has resisted simplification of either contracts or its chart of accounts, in effect asserting that it wishes to continue trying to capture costs and control funds at extremely challenging level of detail.

Other Previously Identified Concerns

In last year's testimony we highlighted the Y2K conversion problem, which DoD did a fine job in overcoming. DFAS had a particularly high-profile role in ensuring that military and civilian payrolls would be met. We also expressed concern about information assurance, fraud and limited oversight of finance operations, particularly vendor pay. We continue to view DFAS as a likely target for hackers and are working closely with the Department to reduce vulnerability to computer crime and other fraud. Unfortunately, other priorities and constrained resources minimized our audit coverage of vendor pay over the

past year, but we will have new audit results in that area later this year.

Conclusion

Mr. Chairman, every time we testify on DoD financial management, we assert that sustained involvement by senior managers and the Congress are vital ingredients for progress. This remains very much the case. Despite commendable progress, the DoD remains far from CFO Act compliance and aggressive measures will be needed over the next few years to achieve success. Therefore the DoD audit community, which has invested so much effort and resources in this area over the past several years, very much appreciates the Subcommittee's interest in our activities and viewpoints. It may also be useful for me to mention that IG, DoD, audit reports are available on the Web at www.dodig.osd.mil. This concludes my statement.

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